

# Creating Long-Term Value in Europe's Capital Markets

Opportunities and constraints



1st Interim Report of the  
CEPS-ECMI Task Force on Asset Allocation in Europe

Brussels, October 2017



## Contents

1. Introduction: Why and how? .....	1
2. Short- vs long-termism: What feeds into investment decisions? .....	2
3. Asset management in Europe: Which way forward? .....	4
4. Conclusions .....	7
5. Next steps.....	7
Annex: Members of the CEPS-ECMI Task Force on Asset Allocation and Group of Experts .....	10

---

# Creating Long-Term Value in Europe's Capital Markets: Opportunities and constraints

## *1st Interim Report of the CEPS-ECMI Task Force on Asset Allocation in Europe*

Cosmina Amariei\*

### 1. Introduction: Why and how?

Capital markets have reached different stages of development throughout Europe, and matching the supply and demand of capital on a cross-border basis remains an elusive goal. As a consequence, the participation of retail investors in capital markets as well as the size and structure of the non-bank financial sector vary significantly across member states. In 2016, the total financial assets of European households and the investment portfolios of asset managers, insurers and pension funds amounted to over €35 trillion each.

Many factors – changing economic/financial conditions, evolving demographics and regulatory as well as technological developments – will impact asset allocation in the coming years. In anticipation of these changes, the Mid-Term Review of the Capital Markets Union (CMU) Action Plan set out new priorities in a number of areas concerning asset allocation: i) fostering retail investment; ii) increasing long-term, infrastructure and sustainable investment; and iii) removing barriers to cross-border investment.

In order to contribute to the policy debate, CEPS and ECMI invited relevant stakeholders – policymakers, industry representatives and academics – to take part in a special Task Force on “Asset Allocation in Europe: What challenges and opportunities lie ahead”. The main objective of this initiative is to substantiate the understanding about the need to facilitate European households’ access to savings products with stable returns over time, and to promote long-term investment through more capital markets-based financial intermediation across the EU.

---

\* Cosmina Amariei is Researcher at the European Capital Markets Institute (ECMI). This first Interim Report is based on the discussions among the members and experts present at the Task Force meeting held on 14 June 2017, but the views expressed in this report are attributable solely to its author. This first Interim Report (and two subsequent ones) will form the basis of the Final Task Force Report, which will put forward a series of policy recommendations supported by in-depth quantitative and qualitative analysis. More detailed and up-to-date information about the Task Force is available [here](#).

To this end, the members of the Task Force<sup>1</sup> have begun to participate in a series of dedicated meetings with the aim of:

- identifying the factors at macro- and micro-level that will drive investment decisions in the short, medium and long run;
- analysing their impact on households/retail investors and on different categories of financial intermediaries; and
- putting forward a list of policy recommendations to strengthen the long-term savings and investment channels in Europe.

The flow chart below explains the various steps in this process.



## 2. Short- vs long-termism: What feeds into investment decisions?

Over the past seven years, the investment climate (real economy and financial sector) has been characterised by falling short- and long-term interest rates, with cyclical and structural drivers reinforcing each other. Most financial intermediaries had to re-examine the notion of risk-free assets, make changes to the composition and risk/return profile of their portfolios and question whether their asset allocation techniques were still working. Higher rates and steeper yield curves are expected soon in Europe, provided that several critical factors materialise, such as strong economic recovery and growth, inflationary pressures and less accommodative monetary policies. Against this background, the members of the Task Force explored the following questions:

- What topics are likely to dominate the investment space in Europe (reflation, low returns, sources of yield, risk diversification)?
- How to foster the participation of households in capital markets? Does the current supply of products meet their needs?
- Are investors equipped for major markets/regulatory/technological shifts? How will these impact their business models and asset allocation strategies?
- Does the current regulatory framework (at national or EU level) provide adequate incentives for long-term, sustainable investment, on a cross-border basis?

---

<sup>1</sup> See the Annex for a list of Task Force Members, Observers and Guests, as well as the members of a Group of Experts formed to provide advice and specialised expertise.

## **Drivers for change**

Among the factors that will determine investment decisions in the coming years are the low/negative interest-rate environment, the competitive market dynamics and the regulatory landscape. The participation of retail investors in capital markets remains limited and their trust in financial services continues to be low (as illustrated by the on-going switch between real estate and financial assets). Financial intermediaries are engaging in maturity and liquidity transformation on behalf of their investors/policy holders. In order to achieve the same level of historical returns (or to match their long-term liabilities), asset managers, private wealth managers and institutional investors started to go beyond the traditional asset classes (cash, equity, bonds) and to move into the unlisted/illiquid space and other alternatives (private debt, equity, infrastructure and direct lending). There is also an increased focus on risk-management techniques and pressure on cost efficiency in the investment community. The regulatory framework (e.g. Solvency 2 and MiFID 2) is expected to have an impact on both the product offerings and the underlying investment strategies.

## **Adequacy of retirement savings**

Generating real positive returns for pensions/retirement savings products is becoming increasingly difficult. While fees and commissions have impacted performance in the past, asset allocation will play an even more important role in the future. With corrections expected in the fixed-income markets due to reverses in monetary policy, there is a renewed emphasis on retail/institutional activity in equity markets, i.e. initiatives aiming at 're-equitising' the investment culture. Direct ownership of shares has collapsed in the last decade. There are also twice as many individual shareholders in primary and secondary markets in mid- and small caps compared to large caps. In Europe, more needs to be done to raise awareness about employee share ownership and to offer tax incentives on investment savings accounts. Moreover, the shares in equity of both insurance companies and pensions have declined in recent years, given the preference for fixed income. The potential shortfall in equity investments of insurance companies is estimated at €350 billion, or 5% of their total investment portfolio. In addition, if pension funds with smaller equity shares in their portfolio were to invest up to the euro-area average, at least 3-5% of total euro area market capitalisation could be added to the demand. Life-cycle investment by pension funds can offer a diversified equity portfolio to policy holders with higher-risk profiles.

## **Financial integration and financial stability**

The financial and sovereign debt crises showed that not only the 'intensity' but also the 'quality' of the overall financial integration matters. Cross-country asset allocation remains low in the euro area. Private risk-sharing channels are not sufficiently developed, with cross-border

---

equity/debt holdings contributing very little to consumption smoothing. The home bias in equity holdings has been diminishing, with the intra-euro area accounting for the reduction more than extra-euro area. Euro area investment funds have increased both their equity and debt exposures to the non-financial sector and sovereign debt markets from the US, emerging markets (EM) and the rest of the EU. The largest holders of debt securities portfolios could be at risk in an environment of abrupt repricing in the fixed income markets. A normalisation of interest rates is desirable provided that this would be triggered by an increase in the 'risk-free' rates as opposed to the risk or term premia. More recently, some institutional investors have shifted to lower-rated securities, to less liquid assets and increased the duration of their portfolios.

### 3. Asset management in Europe: Which way forward?

The asset management industry (investment funds and discretionary mandates) is undergoing fundamental changes. The shift to passive funds is well understood. Active managers are facing growing fee pressures, struggling with the low-interest environment and in some cases underperforming their market benchmarks. As QE reverses, seizing alpha opportunities will become critical for active managers, e.g. crossing over into illiquid and lower-rated alternatives and factor-based investing. End investors will continue to emphasise the absolute level of returns after costs. Regulation, fintech and evolving demographics will also change the contours of the asset management industry. Against this background, the members of the Task Force explored the following questions:

- What factors will affect the asset managers' value proposition to both retail and institutional investors, respectively, in the long run?
- What is the outlook for asset allocation (equity, fixed income, alternatives) and investment strategies (active or passive) for the next five years?
- Will fintech (robo-advisors, big data, DLT) bring about operational efficiencies in the fund industry and expand the client base?
- Are asset managers ready to comply with a new regulatory framework (MiFID 2)?

#### **Asset allocation trends**

The European asset management industry has witnessed solid growth over the past decade, reaching almost €23 trillion in assets under management (AuM) at the end of 2016. The UK is the largest asset management market in Europe, followed by France and Germany. Some 24% of registered investment funds (IF) are domiciled in Ireland and Luxembourg. The asset mix is different for discretionary mandates (DM) and IF, respectively. At end of 2015, bonds made up

---

over one-half of the entire portfolio in DM (52%), compared to 24% for equity, 7% for cash/money market instruments and 17% for other assets. Over 42% of IF assets were invested in equity, and bonds accounted for 29%, compared to 22% for other assets and 8% for cash/money market investments. Most importantly, the share of equity in DM doesn't seem to have returned to the pre-crisis level. There are multiple drivers behind this change, including growing maturities of pension liabilities but also accounting, tax and prudential treatment of equity exposure (Solvency 2). The holdings of cash/money market instruments have declined every year since 2008, whereas there has been a sustained increase in the share of other assets (real estate, infrastructure, hedge funds, structured products, private equity). There is also an increasing focus on sustainability themes, e.g. integration of environmental, social and governance (ESG)/stewardship factors into investment decisions.

### **Retail vs. institutional investors**

The institutional investors account for almost 75% of total assets under management (AuM) in Europe; in the coming years, they are expected to re-consider their strategies with respect to the in(out)-sourcing of asset management or co-investment/partnerships with other institutional investors. Much more needs to be done in order to create a truly pan-European market that is competitive, attractive and transparent vis-à-vis its investors, in particular the retail segment. Only 7% of European households' financial assets are directly invested in investment funds units (excluding indirect investments through insurance and pension products). Developing new solutions for millennials remains a priority, with more asset managers focusing also on financial education tools. It is also important to differentiate among retirees and to better understand the challenges posed by longevity (80+ is the fastest-growing age group).

### **Market fragmentation**

The passport regimes established under UCITS and AIFMD have facilitated significant improvements in cross-border activity and competition. Nonetheless, the European investment funds sector remains highly fragmented, sometimes resulting in sub-optimal size of funds and higher costs for investors. Funds marketed cross-border represent about €5.4 trillion AuM and 57% of all EU funds. More than a quarter, however, is represented by 'round-trip' funds (i.e. funds domiciled in Ireland and Luxembourg). A range of regulatory barriers – e.g. marketing requirements, fee calculations, notification process, local presence and supervisory practices – alongside other reasons such as distribution models, national tax regimes, and investor home-bias, are causing market fragmentation.

---



### **Active vs. passive investment**

The shift of capital from active to passive investments is expected to continue in the next five to ten years, resulting in more price competition, margin compression and industry consolidation. When analysing their respective performance, one should first compare the underlying assets/investment strategy. In general, active funds are more expensive than passive funds, but they are more likely to outperform passive funds in the case of small- and mid-caps or corporate bonds as opposed to large caps or sovereign/government bonds. The rise of passive funds is in fact rebooting the active/value management industry. Asset owners (in particular institutional investors) are renegotiating their contractual terms and demanding greater transparency in investment strategies, fees and costs. The choice to use active or passive funds or a combination of both will depend primarily on the investor profile. Exchange-traded funds (ETFs) have been used for a long time by institutional investors (for tactical positioning or hedging portfolios) and are now gaining a significant foothold in the retail segment. Nonetheless, the real test for passive funds will be their resilience/robustness during market downturns.

### **Technological developments**

In the past four years, many robo-advisors have entered the market, mostly based on passive investments/ETFs. Their AuM are still very small compared to traditional players. The field is presently populated with hybrid models combining algorithm-based investment techniques with traditional professional advice from financial advisors. Robo-advisors are expected to positively impact mass affluent investors in terms of reduced costs, improved access to advice and better product choices. Nonetheless, flaws in the algorithms, mis-selling risks and privacy and data protection concerns could negatively impact their take-up. It is also highly likely that institutional investors and or high net-worth individuals with large portfolios and complex investment needs will continue to favour tailored, personalised solutions.

### **Regulatory headwinds**

At the heart of MiFID 2 lies investor protection and transparency. Many aspects related to the abstract/effective target market, suitability tests, (non-) independent investment advice and research/trading account separation will reshape the relationship between manufacturers, allocators and distributors. In particular, 'captive' and third-party distributors (banks, insurers, independent financial advisors and online platforms) will play an even more important role in the relationship with end-clients. The pressure on fund managers to offer low-cost, high-quality funds is expected to continue.

---

## 4. Conclusions

European households have been increasing their participation in capital markets in recent years. Nonetheless, a more balanced, diversified asset allocation is needed. Enhancing access to products with a rewarding risk-return profile, transparent pricing and cost structures should remain a priority. Moreover, encouraging long-term-oriented financial intermediaries to activate those savings and investment channels could further enable the transition towards more sustainable economic models.

In the investment community, generating real positive returns has become increasingly difficult, given the low-yield environment. Some institutional investors have shifted their portfolio allocation further down the credit risk spectrum, also venturing into assets with increasingly longer maturities and the alternative assets space. In particular, the asset management sector is expected to undergo fundamental changes driven by increased regulatory scrutiny and the new competitive landscape.

## 5. Next steps

The second meeting held on 24 October 2017 delved into **asset allocation trends by/for institutional investors** and the Commission's proposal for a Regulation on a pan-European personal pension product (PEPP). The discussion on these issues is briefly summarised below and will be presented in-depth in the 2<sup>nd</sup> Interim Report.

**Insurance companies.** The insurance sector is the largest institutional investor in Europe and remains highly concentrated in a small number of countries. Despite a shift towards products featuring lower guarantees and a more flexible return structure, non-unit-linked still constitute the bulk of the policies on the balance sheets of life insurers. On the assets side, the process of de-risking has come to a halt and has started to reverse in recent years. Some insurers have been gradually increasing their exposure to higher-yielding debt instruments but also to infrastructure, private equity and direct lending. On average, non-life insurers operate at higher shares of equity than life insurers. Against this background, the members of the Task Force explored the following questions:

- What are most relevant constraints/opportunities on the balance sheets of insurers?
  - Are the concerns about the increasing duration mismatch and re-investment risk warranted? What types of risk management strategies are currently being employed?
  - What are the main drivers behind externalising portfolio management and other types of services (reporting, data analytics, etc.)?
-

- Should prudential regulation be used as tool to (dis)incentivise investment in certain asset classes? Is the current regulatory framework (Solvency 2) conducive to long-term investment?

**Pension funds.** Europe's pension savings gap is projected at around €2 trillion a year, and there is no one 'silver bullet' for solving this increasingly complex problem. Over the last ten years, European pension funds (defined benefit or defined contribution, occupational or personal, mandatory or voluntary plans) have experienced an increase in their investments. At present, there is significant heterogeneity in the asset allocation among member states, with respect to direct or indirect holdings of equity in particular. When it comes to future challenges, the pension product mix (and underlying investment strategy) will have to accommodate the longevity 'risk' and deliver satisfactory and stable returns over time. Against this background, the members of the Task Force explored the following questions:

- What is the outlook for asset allocation (traditional vs alternatives) and investment strategies (active vs passive, cash flow vs liability driven) in the medium and long run?
- Do the main risks for pension funds appear to be on the return portfolio, or rather on the matching portfolio? Does the business model play a significant role?
- Are pension funds reconsidering their in(out)-sourcing of asset management or co-investment/partnerships with other institutional investors?
- What does PEPP need to induce adequate savings for future retirement income? Is it going to be sufficiently attractive for both savers and providers?

The third meeting, to take place in early 2018, will focus the challenges and opportunities for the European **retail investors/households** by looking at the series of relevant themes, such as:

- the main factors influencing the demand and supply of retail savings/investment products, including behavioral aspects, financial literacy, investor/consumer protection;
  - future developments in manufacturing, marketing, distribution, investment/financial advice and transparency in risk-return performance, costs and fees;
  - the interaction among the EU rules (PRIIPS, MiFID 2, IDD, PEPP), non-harmonised legal frameworks (tax, securities, contract, insolvency law) and supervisory convergence.
-

The retail investors must remain at the core of the CMU project. As compared to the US, the European households have more than double the amount of their savings in deposits, but half as much in investment funds and shares. Most notably, the composition of households' financial assets varies considerably across EU Member States due to multiple reasons (investor preferences, market structure and access, regulatory/supervisory frameworks, tax regimes). Retail capital markets services are also barely developed on a cross-border basis, and this translates into very limited cross-border holdings of financial assets.

---

## Annex

### Members of the CEPS-ECMI Task Force on Asset Allocation and Group of Experts

#### Chairman

Jean-Pierre Pinatton, Oddo BHF

#### Rapporteurs

Karel Lannoo, CEPS

Cosmina Amariei, ECMI

Apostolos Thomadakis, ECMI

#### Members of the Group of Experts

Anders Damgaard, PFA Pension

Marco Lamandini, Università di Bologna

Jesper Lau Hansen, University of Copenhagen

Barbara Matthews, BCM International Regulatory Analytics

Luis D.S. Morais, University of Lisbon Law School

Guillaume Prache, Better Finance

Rhodri Preece, CFA Institute

Ole Stæhr, Nordea Wealth Management

#### Task Force Members, Observers and Guests

Nadia Ameli, University College London

Mireille Aubry, Covea

Giuseppe Ballocchi, Alpha Governance Partners

Maciej Bitner, Wise Europa

Claudio Bocci, Prometeia

Jean-Pierre Casey, Edmond de Rothschild

Sibe de Bok, European Investors' Association

Bernard Delbecque, EFAMA

Angelos Delivorias, EPRS

Jean-Luc Filippini, EIB

Sven Gentner, European Commission

Philipp Hartmann, ECB

Tamar Joulia-Paris, TJ Capital

Mark Minichiello, J.P. Morgan Asset Management

Bogdan Pop, ICMA

David Reed, Kreab

Amlan Roy, State Street Global Advisors

Jeff Rupp, INREV

Aneta Spendzharova, Maastricht University

Linda Strazdina, Afore Consulting

Andrej Stuchlik, EPRS

Thomas Tilley, EFAMA

Patricia Wruuck, EIB

## About ECMI – Informing policy on European capital markets

ECMI conducts in-depth research aimed at informing the debate and policy-making process on a broad range of issues related to capital markets. Through its various activities, ECMI facilitates interaction among market participants, policymakers and academics. These exchanges are fuelled by the various outputs ECMI produces, such as regular commentaries, policy briefs, working papers, statistics, task forces, conferences, workshops and seminars. In addition, ECMI undertakes studies commissioned by the EU institutions and other organisations, and publishes contributions from high-profile external researchers.



## About CEPS – Thinking ahead for Europe

CEPS is one of Europe's leading think tanks and forums for debate on EU affairs, with an exceptionally strong in-house research capacity and an extensive network of partner institutes throughout the world. CEPS' commitment to institutional independence is rooted in the independence exercised by each member of its staff. As an organisation, CEPS is committed to carrying out state-of-the-art policy research that addresses the challenges facing Europe and maintaining high standards of academic excellence and unqualified independence and impartiality. It provides a forum for discussion among all stakeholders in the European policy process and works to build collaborative networks of researchers, policy-makers and business representatives across the whole of Europe.

